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TAGS: ECON EFIN PGOV PREL LE

SUBJECT: LEBANON: FINANCE MINISTER CONCERNED ABOUT GOL
FINANCES AND ECONOMIC STAGNATION, OPTIMISTIC ABOUT REFORM

Classified By: Ambassador Jeffrey D. Feltman for reasons 1.4 (b) and (d).).

SUMMARY

¶1. (C) Finance Minister Jihad Azour reported to us that none of the money pledged at Paris III has yet arrived, and Lebanon's short term financial situation is difficult but still manageable. The real problem is that continued political uncertainty is derailing Lebanon's anticipated cycle of economic growth, debt reduction, and improved government services. The Minister downplayed recent friction between the MOF and Banque du Liban (BDL), in reassuring the Ambassador that the BDL is helping the Ministry of Finance (MOF) through its cash crunch. Azour was confident that the GOL can pursue several areas of its reform program, despite the political stalemate, through cabinet and ministerial action. End Summary.

PARIS III PLEDGES HAVE NOT ARRIVED

¶2. (C) Although none of the money pledged at Paris III has yet arrived, Finance Minister Azour told the Ambassador and Econoff on March 14 that the United Arab Emirates has signed an MOU for a USD 300 million, 20-year loan due to arrive in April. The Saudi USD 100 million grant is also expected to come through in April. Other donors are sending delegations to Lebanon: two World Bank teams focused on aid to the electricity sector and supporting the social safety net; a French mission explained that they cannot disburse their aid until the French parliament meets in July; and the Kuwaitis have promised to disburse the USD 300 million they pledged at Stockholm as soon as they form a new cabinet. The GOL is negotiating with other donors to convert some of their offered project aid into debt reduction loans, since Lebanon already has more projects in the pipeline than it can absorb. The Islamic Development Fund is considering shifting some of its USD 250 million in project pledges to budget support.

¶3. (C) The Ministry of Finance (MOF) still has not received a clear message from the commercial banks on their expected, but unspecified, contribution and will ask the Banque du Liban (BDL, Lebanon's central bank) to finalize the plan. Azour said that in light of increased bank profits in 2006, minimal bank losses from the Israeli-Hizballah War, and BDL schemes to help the banks write off losses, the banks should volunteer to help reduce the debt. He intends to ask the BDL to pressure them to do so.

FINANCIAL SITUATION CRITICAL...

¶4. (C) The financial situation is not good and becoming more difficult, Azour told us; short term cash flows are a severe but manageable concern. The cash flow problem stems from expensive Electricite du Liban (EDL) fuel purchases, which drove up MOF borrowing by USD 1.9 billion over the last two years. Resigned Minister of Energy and Water Fneish did not substantially reform EDL, and the management problems at EDL go back at least 10 years.

...BUT THE ECONOMY IS THE REAL CONCERN

¶5. (C) The real problem is that sectarian tension and political uncertainty have prevented Lebanon from benefiting from a post-Paris III boost in growth or confidence, and are still preventing Lebanon's anticipated economic cycle of growth, debt reduction, and improved government services. French technical advisors believe the economy contracted by 3 percent in the first quarter compared to the exceptionally strong performance in the first quarter of 2006. The quick post-July business recovery had led the GOL to expect, and to build its scenarios on, strong 2007 growth. With the political situation "gloomy, with no light at the end of the tunnel," market demand for Eurobonds has stagnated and the GOL is coming close to exhausting its legislatively limited borrowing allowance. Even so, there is still no pressure on the Lebanese pound. On a positive note, the Prime Minister and Cabinet are concerned, meeting frequently to talk about economic issues, and pushing back against politicians who ask for increased spending and reform delays.

¶6. (C) Thus far the dire situation has not caused panic, and

BEIRUT 00000403 002 OF 003

the economy has not seen deposit outflows or unusually high currency conversions. The largest tranche of maturing debt for the year was dealt with in February. If the GOL can control its spending and EDL can stem its losses, the government's financial situation will remain less than ideal but not completely off track. Fortunately, the political opposition's leaders do not yet recognize the GOL's financial vulnerability, but even if they did they wouldn't know how to take advantage of that vulnerability. Even commercial bankers sympathetic to the opposition would not let them exploit the tenuous state of the GOL's finances, Azour told us.

¶7. (C) The political situation makes it impossible for the MOF to use an IMF program to pressure domestic opponents of reform. The opposition would say that Lebanon is losing its sovereignty if the GOL tried to use IMF commitments to justify reforms. The GOL has thus far been silent about the economic contraction out of fear the downturn could further affect market confidence. Nevertheless, March 14 should flag this as a consequence of the opposition's actions, Azour said. The same economic developments are decreasing the opposition's popularity and that of General Aoun in particular.

FINANCE MINISTRY AND
CENTRAL BANK COOPERATING

¶8. (C) The Minister downplayed recent friction between the MOF and BDL, which emboffs observed in late February as a USD 1 billion tranche of Eurobonds came due. The BDL paid off the entire tranche, Azour clarified for us, and took on the USD 550 million in what had been market-held debt in addition to the USD 450 million it was already holding. In return, the MOF promised to pay the BDL with a new USD 1 billion Eurobond issue, which two commercial banks are already preparing. The absorption of USD 560 million in market debt means the MOF can be permitted another issuance, despite its need for parliamentary approval to exceed its current debt

ceiling. The political situation is contributing to low market confidence, Azour told us, and the investment banks say rumors that the GOL will increase its debt are already affecting expected bond prices. That new USD 1 billion in conjunction with the at least USD 400 expected to arrive from Saudi Arabia and the Emirates over the next few months should cover Lebanon's borrowing needs for the year, Azour assessed.

¶ 9. (C) The BDL has not transferred USD 1.5 billion in profits on gold owed to the MOF for three years, and the two organizations are working to clear up the BDL balance sheet, Azour explained. To avoid inflation, the MOF will not spend the money but will use it to retire debt held by the BDL. If gold prices drop, Azour noted, the GOL would be obligated to recapitalize the BDL. In addition, the MOF is a net borrower from the BDL of about USD 500 million.

¶ 10. (C) The IMF has insisted that the BDL disclose its net reserves to the IMF, but agreed that it would not let that information leak to the market in order to avoid speculation on the Lebanese pound. The IMF and the BDL may still be debating how those net reserves will be calculated. There is no major difference between the MOF and BDL on Lebanon's economic reform program, Azour told us, although the BDL has specific concerns about disclosure. Both want a program that is good for Lebanon's long term prospects. Azour believed that the IMF will gradually introduce more discipline, and Lebanon's financial culture will adjust to this. "The perfect is the enemy of the good," Azour reminded us, and said that the IMF must present a proposal that is realistic given the political situation.

REFORM PROCEEDING

¶ 11. (C) Azour was confident that the GOL can pursue several areas of its reform program despite the political stalemate, and has built a small buffer into the IMF's benchmarks without reneging on the GOL's commitments. The cabinet is still engaged, and those reforms that involve an improvement in management, such as social security and power sector reform, are still possible. "This is a lost time in politics, so we are better off focusing on economics," Azour suggested. In fact, there may be fewer politically-motivated objections, as many figures are distracted by the political stalemate.

BEIRUT 00000403 003 OF 003

¶ 12. (C) To boost Lebanon's weak capacity and track record on implementation, the GOL is using a new Booz Allen Project Management Office (BAPMO) to monitor and support implementation of the reform program. With a monitoring system in place, it will be hard for any ministry to justify its failure to live up to its commitments. There are many preparations for reform -- in particular telecom and power reform -- that can be accomplished without action by parliament, that is, they can be done through cabinet or ministerial decrees. The Cabinet met three times this past week to discuss reform plans. (Note: In a separate meeting on March 13, Ministry of Economy and Trade officials told us that the cabinet is now meeting frequently, discussing many issues, and focusing on economic reform. End Note.) In fact, Azour told us, an International Finance Corporation (IFC) official recently witnessed the GOL's first approval for an independent power producer.

¶ 13. (C) The International Monetary Fund (IMF) team now in Lebanon is expected to conclude negotiations this week. The team is further expected to give the final staff approval to the program proposal early next week before taking that proposal to the IMF board. Azour said he was certain that the IMF board and its Middle East Department will support the program, but admitted that the policy review and financial departments are less comfortable committing themselves to a program for Lebanon. Negotiations have not been especially

difficult, from Azour's perspective, and he received cabinet approval for the broad lines of what is under negotiation. The "monitorable actions" or benchmarks in the program are a selective set derived from the Paris III paper. (Note: A MOET advisor in a separate meeting told us that the Emergency Post-Conflict Assistance will give Lebanon access to 25 percent of its quota immediately upon signing, rather than disbursing in tranches as various benchmarks are met. He also believes BDL negotiations specifically and GOL negotiations generally with the IMF are essentially complete, except for some "nitty-gritty technical details." End Note.)

FELTMAN